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Total	500.00
Foreign income taxes imposed on or with respect to gains, profits, and income	200.00
Accumulated profits	500.00
Foreign income taxes paid by A Corp. on or with respect to its accumulated profits (total foreign income taxes)	200.00
Accumulated profits in excess of foreign taxes ...	300.00
Foreign income taxes paid, and deemed to be paid, by A Corp. for 1977 on or with respect to its accumulated profits for such year (\$45+\$200)	245.00
Dividends paid on Feb. 15, 1978 to M Corp	100.00
M Corp. (domestic shareholder):	
Foreign income taxes of A Corp. for 1977 deemed paid by M Corp. for 1978 under section 902(a)(1) (\$245×\$100/\$300)	81.67
Foreign income taxes included in gross income of M Corp. under section 78 as a dividend received from A Corp	81.67

(1) *Effective date.* Except as provided in § 1.902-4, this section applies to any distribution received from a first-tier corporation by its domestic shareholder after December 31, 1964, and before the beginning of the foreign corporation's first taxable year beginning after December 31, 1986. If, however, the first day on which the ownership requirements of section 902(c)(3)(B) and § 1.902-1(a)(1) through (4) are met with respect to the foreign corporation is in a taxable year of the foreign corporation beginning after December 31, 1986, then this section shall apply to all taxable years beginning after December 31, 1964, and before the year in which the ownership requirements are first met. See § 1.902-1(a)(13)(i). For corresponding rules applicable to distributions received by the domestic shareholder prior to January 1, 1965, see § 1.902-5 as contained in the 26 CFR part 1 edition revised April 1, 1976.

[T.D. 7481, 42 FR 20125, Apr. 18, 1977, as amended by T.D. 7490, 42 FR 30497, June 15, 1977; T.D. 7649, 44 FR 60086, Oct. 18, 1979. Redesignated and amended by T.D. 8708, 62 FR 927, 940, Jan. 7, 1997; 62 FR 7155, Feb. 18, 1997]

§ 1.902-4 Rules for distributions attributable to accumulated profits for taxable years in which a first-tier corporation was a less developed country corporation.

(a) *In general.* If a domestic shareholder receives a distribution from a first-tier corporation before January 1, 1978, in a taxable year of the domestic shareholder beginning after December 31, 1964, which is attributable to accumulated profits of the first-tier corporation for a taxable year beginning

before January 1, 1976, in which the first-tier corporation was a less developed country corporation (as defined in 26 CFR § 1.902-2 revised as of April 1, 1978), then the amount of the credit deemed paid by the domestic shareholder with respect to such distribution shall be calculated under the rules relating to less developed country corporations contained in (26 CFR § 1.902-1 revised as of April 1, 1978).

(b) *Combined distributions.* If a domestic shareholder receives a distribution before January 1, 1978, from a first-tier corporation, a portion of which is described in paragraph (a) of this section, and a portion of which is attributable to accumulated profits of the first-tier corporation for a year in which the first-tier corporation was not a less developed country corporation, then the amount of taxes deemed paid by the domestic shareholder shall be computed separately on each portion of the dividend. The taxes deemed paid on that portion of the dividend described in paragraph (a) shall be computed as specified in paragraph (a). The taxes deemed paid on that portion of the dividend described in this paragraph (b), shall be computed as specified in § 1.902-3.

(c) *Distributions of a first-tier corporation attributable to certain distributions from second- or third-tier corporations.* Paragraph (a) shall apply to a distribution received by a domestic shareholder before January 1, 1978, from a first-tier corporation out of accumulated profits for a taxable year beginning after December 31, 1975, if:

(1) The distribution is attributable to a distribution received by the first-tier corporation from a second- or third-tier corporation in a taxable year beginning after December 31, 1975.

(2) The distribution from the second- or third-tier corporation is made out of accumulated profits of the second- or third-tier corporation for a taxable year beginning before January 1, 1976, and

(3) The first-tier corporation would have qualified as a less developed country corporation under section 902(d) (as in effect on December 31, 1975), in the taxable year in which it received the distribution.

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(d) *Illustrations.* The application of this section may be illustrated by the following examples:

Example 1. M, a domestic corporation owns all of the one class of stock of foreign corporation A. Both corporations use the calendar year as the taxable year. A Corporation pays a dividend to M Corporation on January 1, 1977, partly out of its accumulated profits for calendar year 1976 and partly out of its accumulated profits for calendar year 1975. For 1975 A Corporation qualified as a less developed country corporation under the former section 902(d) (as in effect on December 31, 1975). M Corporation is deemed under paragraphs (a) and (b) of this section to have paid \$63 of foreign income taxes paid by A Corporation on or with respect to its accumulated profits for 1976 and 1975 and M Corporation includes \$36 of that amount in gross income as a dividend under section 78, determined as follows upon the basis of the facts assumed:

1976	
Gains, profits, and income of A Corp. for 1976	\$120.00
Foreign income taxes imposed on or with respect to such gains, profits, and income	36.00
Accumulated profits	120.00
Foreign income taxes paid by A Corp. on or with respect to its accumulated profits (total foreign income taxes)	36.00
Accumulated profits in excess of foreign income taxes	84.00
Dividend to M Corp. out of 1976 accumulated profits	84.00
Foreign income taxes of A for 1976 deemed paid by M Corp. ($\$84/\$84 \times \$36$)	36.00
Foreign income taxes included in gross income of M Corp. under section 78 as a dividend from A Corp.	36.00
1975	
Gains, profits, and income of A Corp. for 1975	\$257.14
Foreign income taxes imposed on or with respect to such gains, profits, and income	77.14
Accumulated profits (under section 902(c)(1)(B) as in effect prior to amendment by the Tax Reform Act of 1976)	180.00
Foreign income taxes paid by A Corp. on or with respect to its accumulated profits ($\$77.14 \times \$180/\$257.14$)	54.00
Dividend to M Corp. out of accumulated profits of A Corp. for 1975	90.00
Foreign income taxes of A Corp. for 1975 deemed paid by M Corp. (under section 902(a)(2) as in effect prior to amendment by the Tax Reform Act of 1976) ($\$54 \times \$90/\$180$) ...	27.00
Foreign income taxes included in gross income of M Corp. under section 78 as a dividend from A Corp.	0

Example 2. The facts are the same as in example 1, except that the distribution from A Corporation to M Corporation on January 1, 1977, was from accumulated profits of A Corporation for 1976. A Corporation's accumulated profits for 1976 were made up of income from its trade or business, and a dividend paid by B, a second-tier corporation in 1976.

The dividend from B Corporation to A Corporation was from accumulated profits of B Corporation for 1975. A Corporation would have qualified as a less developed country corporation for 1976 under the former section 902(d) (as in effect on December 31, 1975). M Corporation is deemed under paragraphs (b) and (c) of this section to have paid \$543 of the foreign taxes paid or deemed paid by A Corporation on or with respect to its accumulated profits for 1976, and M Corporation includes \$360 of that amount in gross income as a dividend under section 78, determined as follows upon the basis of the facts assumed:

Total gains, profits, and income of A Corp. for 1976	\$1,500
Gains and profits from business operations	1,200
Gains and profits from dividend A Corp. received in 1976 from B Corp. out of accumulated profits of B Corp. for 1975	300
Foreign taxes imposed on or with respect to such profits and income	450
Foreign taxes paid by A Corp. attributable to gains and profits from A Corp.'s business operations	360
Foreign taxes paid by A Corp. attributable to dividend from B Corp. in 1976	90
Dividends from A Corp. to M Corp. on Jan. 1, 1977	1,050
Portion of dividend attributable to gains and profits of A Corp. from business operations. ($\$1,200/\$1,500 \times \$1,050$)	840
Portion of dividends attributable to gains on profits of A Corp. from dividend from B Corp. ($\$300/\$1,500 \times \$1,050$)	210
(a) <i>Amount of foreign taxes of A Corp. deemed paid by M Corp. on A Corp.'s gains and profits for 1976 from business operations.</i>	
Gains, profits, and income of A Corp. from business operations	\$1,200
Foreign income taxes imposed on or with respect to gains, profits, and income	360
Accumulated profits	1,200
Foreign income taxes paid by A Corp. on or with respect to its accumulated profits (total foreign income taxes)	360
Accumulated profits in excess of foreign income taxes	840
Dividend to M Corp.	840
Foreign taxes of A Corp. deemed paid by M Corp. ($\$360 \times \$840/\$840$)	360
Foreign taxes included in gross income of M Corp. under section 78 as a dividend	360

(b) *Amount of foreign taxes of A Corp. deemed paid by M Corp. on portion of the dividend attributable to B Corp.'s accumulated profits for 1975.*

B Corp. (second-tier corporation):	
Gains, profits, and income for calendar year 1975	\$1,000
Foreign income taxes imposed on or with respect to gains, profits, and income	400
Accumulated profits (under section 902(c)(1)(B) as in effect prior to amendment by the Tax Reform Act of 1976)	600

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Foreign income taxes paid by B Corp. on or with respect to its accumulated profits (\$400×\$600/\$1,000)	240
Dividend to A Corp. in 1976	300
Foreign taxes of B Corp. for 1975 deemed paid by A Corp. (under section 902(b)(1)(B) as in effect prior to amendment by the Tax Reform Act of 1976) (\$240×\$300/\$600)	120
A Corp. (first-tier corporation):	
Gains, profits, and income for 1976 attributable to dividend from B Corp.'s accumulated profits for 1975	300
Foreign income taxes imposed on or with respect to such gains, profits, and income	90
Accumulated profits (under section 902(c)(1)(B) as in effect prior to amendment by the Tax Reform Act of 1976)	210
Foreign taxes paid by A Corp. on or with respect to such accumulated profits (\$90×\$210/\$300)	63
Foreign income taxes paid and deemed to be paid by A Corp. for 1976 on or with respect to such accumulated profits (\$120 + \$63)	183
Dividend paid to M Corp. attributable to dividend from B Corp. out of accumulated profits for 1975)	210
Foreign taxes of A Corp. deemed paid by M Corp. (under section 902(a)(2) as in effect prior to amendment by the Tax Reform Act of 1976) (\$183×\$210/\$210)	183
Amount included in gross income of M Corp. under section 78	0

[T.D. 7649, 44 FR 60087, Oct. 18, 1979. Redesignated and amended by T.D. 8708, 62 FR 927, 940, Jan. 7, 1997]

§ 1.903-1 Taxes in lieu of income taxes.

(a) *In general.* Section 903 provides that the term “income, war profits, and excess profits taxes” shall include a tax paid in lieu of a tax on income, war profits, or excess profits (“income tax”) otherwise generally imposed by any foreign country. For purposes of this section and §§ 1.901-2 and 1.901-2A, such a tax is referred to as a “tax in lieu of an income tax”; and the terms “paid” and “foreign country” are defined in § 1.901-2(g). A foreign levy (within the meaning of § 1.901-2(g)(3)) is a tax in lieu of an income tax if and only if—

(1) It is a tax within the meaning of § 1.901-2(a)(2); and

(2) It meets the substitution requirement as set forth in paragraph (b) of this section.

The foreign country's purpose in imposing the foreign tax (*e.g.*, whether it imposes the foreign tax because of administrative difficulty in determining the base of the income tax otherwise generally imposed) is immaterial. It is also immaterial whether the base of the foreign tax bears any relation to

realized net income. The base of the tax may, for example, be gross income, gross receipts or sales, or the number of units produced or exported. Determinations of the amount of a tax in lieu of an income tax that is paid by a person and determinations of the person by whom such tax is paid are made under § 1.901-2 (e) and (f), respectively, substituting the phrase “tax in lieu of an income tax” for the phrase “income tax” wherever the latter appears in those sections. Section 1.901-2A contains additional rules applicable to dual capacity taxpayers (as defined in § 1.901-2(a)(2)(ii) (A)). The rules of this section are applied independently to each separate levy (within the meaning of §§ 1.901-2(d) and 1.901-2A (a)) imposed by the foreign country. Except as otherwise provided in paragraph (b)(2) of this section, a foreign tax either is or is not a tax in lieu of an income tax in its entirety for all persons subject to the tax.

(b) *Substitution*—(1) *In general.* A foreign tax satisfies the substitution requirement if the tax in fact operates as a tax imposed in substitution for, and not in addition to, an income tax or a series of income taxes otherwise generally imposed. However, not all income derived by persons subject to the foreign tax need be exempt from the income tax. If, for example, a taxpayer is subject to a generally imposed income tax except that, pursuant to an agreement with the foreign country, the taxpayer's income from insurance is subject to a gross receipts tax and not to the income tax, then the gross receipts tax meets the substitution requirement notwithstanding the fact that the taxpayer's income from other activities, such as the operation of a hotel, is subject to the generally imposed income tax. A comparison between the tax burden of this insurance gross receipts tax and the tax burden that would have obtained under the generally imposed income tax is irrelevant to this determination.

(2) *Soak-up taxes.* A foreign tax satisfies the substitution requirement only to the extent that liability for the foreign tax is not dependent (by its terms or otherwise) on the availability of a credit for the foreign tax against income tax liability to another country.